

fair market value of any related or subsidiary services performed in connection with such sale or leases or methods based on gross receipts or costs of goods sold, where appropriate.

(b) *Deductions.* For purposes of section 995(b)(3)(A)(ii), deductions shall be properly allocated and apportioned to gross income, described in paragraph (a) of this section, in accordance with the rules of §1.861-8. These deductions include all applicable deductions from gross income provided under part VI of subchapter B of chapter 1 of the Code.

(c) *Military property.* For purposes of this section, the term *military property* means any property which is an arm, ammunition, or implement of war designated in the munitions list published pursuant to section 38 of the International Security Assistance and Arms Export Control Act of 1976 (22 U.S.C. 2778 which superseded 22 U.S.C. 1934) and the regulations thereunder (22 CFR 121.01).

(d) *Illustration.* The principles of this section may be illustrated by the following example:

*Example.* X Corporation elects to be a DISC for the first time in 1976. X has taxable income of \$50,000, of which \$30,000 is attributable to military property and \$10,000 to interest on producer's loans. The total deemed distributions with respect to X are as follows:

|  |          |
|--|----------|
| (1) Gross interest from Producer's loans in 1976   | \$10,000 |
| (2) 50 percent of the taxable income of the DISC attributable to military property in 1976                               | 15,000   |
| (3) One-half of the excess of taxable income for 1976 over the sum of lines (1) and (2) (½ of (\$50,000 minus \$25,000)) | 12,500   |
| (4) Total deemed distributions (sum of total lines (1), (2), and (3))  | 37,500   |

(Secs. 995(e)(7), (8) and (10), 995(g) and 7805 of the Internal Revenue Code of 1954 (90 Stat. 1655, 26 U.S.C. 995 (e)(7), (8) and (10); 90 Stat. 1659, 26 U.S.C. 995(g); and 68A Stat 917, 26 U.S.C. 7805))

[T.D. 7984, 49 FR 40019, Oct. 12, 1984]

#### § 1.996-1 Rules for actual distributions and certain deemed distributions.

(a) *General rule.* Under section 996(a)(1), any actual distribution (other than a distribution described in paragraph (b) of this section or to which §1.995-4 applies) to a shareholder by a DISC, or former DISC, which is made out of earnings and profits shall be treated as made—

(1) First, out of “previously taxed income” (as defined in §1.996-3(c)) to the extent thereof,

(2) Second, out of “accumulated DISC income” (as defined in §1.996-3(b)) to the extent thereof, and

(3) Third, out of “other earnings and profits” (as defined in §1.996-3(d)) to the extent thereof.

(b) *Rules for qualifying distributions and deemed distributions under section 995(b)(1)(G).*—(1) *In general.* Except as provided in subparagraph (2), any actual distribution to meet qualification requirements made pursuant to §1.992-3 and any deemed distribution pursuant to §1.995-2(a)(5) (relating to foreign investment attributable to producer's loans) which is made out of earnings and profits shall be treated as made—

(i) First, out of “accumulated DISC income” (as defined in §1.996-3(b)) to the extent thereof.

(ii) Second, out of “other earnings and profits” (as defined in §1.996-3(d)) to the extent thereof, and

(iii) Third, out of “previously taxed income” (as defined in §1.996-3(c)) to the extent thereof.

(2) *Special rule.* For taxable years beginning after December 31, 1975, paragraph (b)(1) of this section shall apply to one-half of the amount of an actual distribution made pursuant to §1.992-3 to satisfy the condition of §1.992-1(b) (the gross receipts test) and paragraph (a) of this section shall apply to the remaining one-half of such amount.

(c) *Exclusion from gross income.* Under section 996(a)(3), amounts distributed out of previously taxed income shall be excluded by the distributee from gross income. However, see §1.996-5(b) for treatment as gain from the sale or exchange of property of the portion of an actual distribution out of previously taxed income to the extent it exceeds the adjusted basis of the stock with respect to which the distribution is made.

(d) *Priority of distributions.* Under section 996(c), for purposes of determining their treatment under paragraphs (a), (b), and (c) of this section, distributions made during a taxable year shall be treated as being made in the following order—

(1) Deemed distributions under §§1.995-2 and 1.995-3.

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(2) Actual distributions to meet qualification requirements made pursuant to § 1.992-3 in the order in which they are made, and

(3) Other actual distributions in the order in which they are made.

Thus, the treatment of any distribution shall be determined after the divisions of earnings and profits have been properly adjusted by taking into account distributions of higher priority which are made or deemed made during the same taxable year.

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

*Example 1.* Y Corporation, which uses the calendar year as its taxable year elects to be treated as a DISC beginning with 1972. During 1973, Y makes a cash distribution of \$100 to X Corporation, Y's sole shareholder. For 1973, Y has no earnings and profits. As of the beginning of 1973, Y has \$300 of accumulated earnings and profits, which consist of \$70 of accumulated DISC income, \$40 of previously taxed income, and \$190 of other earnings and profits. The entire \$100 distribution is a dividend under section 316. However, \$40 thereof is treated as made out of previously taxed income and is thus excluded from gross income. Accordingly, only \$60 is treated as distributed out of accumulated DISC income and includible in gross income. See § 1.246-4 for the inapplicability of the dividend received deduction with respect to the entire distribution of \$100.

*Example 2.* Assume the same facts as in example 1, except that the cash distribution is designated as a distribution to meet qualification requirements made pursuant to § 1.992-3. Under these facts, X includes the entire distribution in its gross income as a dividend. Of the \$100 distributed, \$70 is treated as made out of accumulated DISC income and the remaining \$30 is treated as made out of other earnings and profits. The dividend received deduction under section 243 is available only with respect to such \$30.

*Example 3.* Y Corporation, which uses the calendar year as its taxable year, elects to be treated as a DISC beginning with 1972. As of the end of 1975, Y had failed to meet the gross receipts test for that year. In 1975 Y had \$100 of taxable income, \$80 of which was attributable to qualified export receipts and \$20 of which was attributable to receipts that did not qualify as qualified export receipts. As of the beginning of 1976, Y had \$300 of accumulated earnings and profits, which consisted of \$70 of accumulated DISC income, \$40 of previously taxed income, and \$190 of other earnings and profits. In 1976 Y makes a cash distribution of \$20 pursuant to § 1.992-3 in order to satisfy the gross receipts test for

1975. For 1976 Y has no earnings and profits and no deemed distributions. The entire \$20 distribution is a dividend under section 316. Under § 1.996-1(b)(2), half of the \$20 cash distribution is treated pursuant to § 1.996-1(b)(1) and half is treated pursuant to § 1.996-1(a). Thus, \$10 is treated as distributed out of accumulated DISC income and is includible in gross income. The other \$10 is treated as made out of previously taxed income and is thus excluded from gross income. As of the beginning of 1977, Y has \$280 of accumulated earnings and profits, which consists of \$60 of accumulated DISC income, \$30 of previously taxed income, and \$190 of other earnings and profits.

[T.D. 7324, 39 FR 35120, Sept. 30, 1974, as amended by T.D. 7854, 47 FR 51742, Nov. 17, 1982]

### § 1.996-2 Ordering rules for losses.

(a) *In general.* Under section 996(b), if for any taxable year a DISC, or a former DISC, incurs a deficit in earnings and profits, such deficit shall be charged—

(1) First, to other earnings and profits (as defined in § 1.996-3(d)) to the extent thereof,

(2) Second, to accumulated DISC income (as defined in § 1.996-3(b)) to the extent thereof, subject to the special rule in paragraph (b) of this section,

(3) Third, to previously taxed income (as defined in § 1.996-3(c)) to the extent thereof, and

(4) To the extent that the amount of such deficit exceeds the sum of the amounts charged in accordance with subparagraphs (1), (2), and (3) of this paragraph, to other earnings and profits (as defined in § 1.996-3(d)).

Thus, the excess deficit charged to other earnings and profits under subparagraph (4) of this paragraph will create a deficit therein in the amount of such excess. To determine the amount of any division of earnings and profits for the purpose of determining under § 1.996-1 the treatment of any actual and certain deemed distributions, the portion of a deficit in earnings and profits chargeable under this paragraph to such division prior to such distribution shall be determined in a manner consistent with the rules in § 1.316-2(b) for determining the amount of earnings and profits available on the date of any distribution.

(b) *Deficits subsequent to a disqualification.* A deficit in earnings and profits of